CALIFORNIA STATE TEACHERS' RETIREMENT BOARD

INVESTMENT COMMITTEE

Subject:	Credit Enhancement Program- School Bond Credit Enhancement	Item Number:	5
		Attachment(s):	3
Action:	X	Date of Meeting:	June 2, 1999
Information:		Presenters:	Mr. Rose

EXECUTIVE SUMMARY

One of the objectives for the Investment Branch is to "Establish a School Bond Credit Enhancement Program." The purpose of this agenda item is to provide an update on program developments regarding the possible role for the California State Teachers' Retirement System (CalSTRS) as a credit enhancer for California public schools.

Background on the existing Credit Enhancement Program and documentation on the proposed expansion for school bond credit enhancement is provided in Attachment 1.

Brief descriptions and discussions on Certificates of Participation (COP) and abatement risk are included in Attachment 2.

RECOMMENDATION

Staff recommends approval of the resolution included in Attachment 3 formally authorizing the participation of school districts and other employing agencies in the existing credit enhancement program and directing staff to work with the California School Financing Authority to develop the appropriate school bond credit enhancement structure.

Background

The role of the Credit Enhancement Program (Program) is to provide fee income. Credit enhancement, as defined in the Business Plan, substitutes a highly rated financial institution's credit rating for that of a lower rated public or private entity. It may be an agreement by a third party (CalSTRS) to be responsible for scheduled interest and/or principal payments in the event the primary obligor does not meet the terms and conditions of the bond indenture (Letter-of-Credit). It may also be an agreement to purchase, on a standby basis, bonds in order to guarantee their marketability (liquidity facility). This substitution, for a fee, allows the public or private entity access to the capital markets at a lower interest rate.

Participation by School Districts and Other Employing Agencies in the Existing Credit Enhancement Program

Since 1994, CalSTRS has been providing Credit Enhancement to governmental entities and private activity corporations providing industrial development, healthcare, pollution control, and multifamily housing.

The Program primarily serves issuers accessing capital markets seeking variable rate debt. The Program serves a variety of different market sectors including cities, redevelopment agencies, city enterprise units, and private activity issuers such as industrial development, pollution control, and multifamily housing.

Existing Credit Enhancement Program policy allows CalSTRS to provide credit enhancement to California school districts and other employing agencies up to the 25% IRS Safe Harbour guideline. In making the investment decision, staff must utilize the same criteria as other credit enhancement opportunities. One requirement is that the enhanced entity must be investment grade or equivalent.

Staff believes that for transactions completed under the existing Program, where the enhanced entity has an investment grade rating, the inclusion of intercept language may result in a disincentive for issuers to participate. Consequently, staff proposes that the use of an intercept under the existing program be evaluated and implemented by staff on a case-by-case basis.

Summary of Existing Program Terms and Conditions

SCHOOL ISSUING AUTHORITY: To be determined

CREDIT UNDERWRITERS: 25% CalSTRS, 75% other financial institutions, primarily commercial banks

UNDERWRITING TERM: Typically 3-7 years, at which time the credit underwriters can exit the commitment provided there is a substitute credit provider

INTEREST RATE: Variable Rate, typically adjusted each week. Fixed rate set by market at bond issuance

FINANCING VEHICLE: Certificates of Participation or General Obligation Bonds

UNDERWRITING STANDARDS: To be determined by the credit underwriters

INTERCEPT BY STATE CONTROLLER: On a case-by-case basis.

ROLE FOR CALSTRS: Letter-of Credit or Liquidity Facility

RISKS TO CALSTRS: Credit risk of the employing agency and abatement risk for certificate of participation

School Bond Credit Enhancement Program (In Development)

Staff has completed the initial development work on a school bond enhancement program over the past year. They have worked with the State Controller, State Treasurer, State Superintendent of Public Instruction, as well as private sector entities.

The school bond credit enhancement program would serve California public school districts. The program structure would utilize the California School Finance Authority (CSFA) to be the conduit issuer of bonds for local school districts. A representative from CSFA will be available at the Investment Committee to answer questions regarding CSFA's role in the process.

The school bond credit enhancement program is in development stage and will be brought before the CSFA Board in June. Representatives from CSFA and CalSTRS have discussed various program options with investment bankers, credit rating agencies, and commercial bankers. It is anticipated that there will be a menu of financing options from which school districts can choose, based either on a fixed rate or variable rate structure. Within the variable rate and fixed rate structures it is anticipated that a pooling concept will be used with an intercept. The variable rate program would cover both the Letter-of-Credit and Liquidity Facility options. The fixed rate program covers only a Letter-of-Credit option that is yet to be developed.

Variable Rate Program

This program is aimed at issuers who seek to benefit from the potential savings involved with floating rate debt on either an interim or a long-term basis. While historically floating rate securities have been a less expensive method of borrowing, there is an additional risk element called "interest rate risk". Interest rate risk is the risk associated with higher interest expenses caused by a rising interest rate environment. While the interest rate savings of variable rate borrowing can offset this risk, borrowers can be hurt financially. An advantage of the variable rate program is that sophisticated borrowers can inexpensively switch to fixed rate debt if interest rates drop to lower levels.

Summary of Variable Rate Program Terms and Conditions

SCHOOL ISSUING AUTHORITY: California School Financing Authority

CREDIT UNDERWRITERS: 25% CalSTRS, 75% other financial institutions, primarily commercial banks

UNDERWRITING TERM: Typically 3-5 years, at which time the credit underwriters can exit the commitment provided there is a substitute credit provider

INTEREST RATE: Variable Rate, typically adjusted each week

FINANCING VEHICLE: Certificates of Participation or General Obligation Bonds

UNDERWRITING STANDARDS: To be determined by the credit underwriters

INTERCEPT BY STATE CONTROLLER: There will be one option using the intercept language for smaller issues, unrated or non-investment grade entities, and/or issuances on behalf or a pool of school districts. There will be another option not using intercept language for higher rated entities.

ROLE FOR CALSTRS: Letter-of Credit or Liquidity Facility

RISKS TO CALSTRS: Credit risk of the employing agency and abatement risk for certificate of participation

The variable rate program is the niche where staff believes that CalSTRS can add the most value in the process.

Fixed Rate Program

This program is targeted at issuers who seek to benefit from fixed rate long-term financing. While fixed rates tend to be a higher cost than variable rate debt, they eliminate "interest rate risk" and are easier for an issuer to administer. During periods of low interest rates, fixed rate debt allows issuers to lock in low rates until maturity. Sophisticated borrowers may seek to issue variable rate debt at higher rates and convert to fixed rate debt when interest rates reach lower levels.

In some cases, an AAA rated bond insurer would be the primary underwriter of risk. The bond insurer would rely principally on the intercept mechanism activated by the State Controller. One option under consideration is for CalSTRS to provide a Stand-By Letter-of-Credit. In the event a school district failed to make a principal and/or interest payment as scheduled, CalSTRS would be required to make that interest and/or principal payment to the bondholders.

Summary of Fixed Rate Program Terms and Conditions

SCHOOL ISSUING AUTHORITY: California School Financing Authority

CREDIT UNDERWRITERS: Bond insurer(s)

UNDERWRITING TERM: To maturity, up to 30 years

INTEREST RATE: Fixed rate set at the time of issuance

FINANCING VEHICLE: Certificates of Participation or General Obligation Bonds

UNDERWRITING STANDARDS: To be determined by the credit underwriters

INTERCEPT BY STATE CONTROLLER: There will be one option using the intercept language for smaller issues, unrated or non-investment grade entities, and/or issuances on behalf of a pool of school districts. There will be another option not using intercept language for higher rated entities.

ROLE FOR CALSTRS: Letter-of Credit

RISKS TO CALSTRS: Credit risk of the employing agency and abatement risk for certificate of participation

The fixed rate program is the niche where staff believes that CalSTRS can add some value in the process.

CREDIT RISK

While some of the debt issued under the proposed School Bond Credit Enhancement Program may take the form of General Obligation bonds, which are backed by the full faith and credit of the issuing entity, it is anticipated that most of the debt issued under the program would be in the form of a Certificate of Participation (COP).

A COP is not, strictly speaking, a bond. Rather, it is a method of structuring and distributing tax-exempt leases to investors by dividing the rental payments and lease into shares for individual sale to investors. The share is represented by a formal certificate, much like a bond. This financing method is used to avoid constitutional (e.g., voter approval) or other legal restrictions on the use of GO debt. Leases underlying the COPs are payable solely from the annual general fund appropriation process. COPs are an accepted method of financing capital projects in California. California COPs differ from those of other states as California municipal governments are allowed to covenant both to budget and appropriate lease payments annually, and this covenant is legally enforceable.

COPs must be structured in such a way as not to be viewed as debt but rather as actual lease obligations. Two aspects of the lease structure are generally perceived as risks: (1) abatement risk and (2) the absence of an acceleration provision. In order for a school district to be obligated to pay the COP lease payments, the school district must be getting beneficial use from the property. A damaged or otherwise non-functioning school facility does not provide beneficial use and the school district would not be legally obligated to make payments on the COPs (e.g., their obligation would be “abated.” To mitigate this risk, the school district provides rental interruption insurance that assures payment of the lease and COPs during any repair period. No acceleration provision of the outstanding debt exists for a COP, in the event of a draw against the credit enhancement. However, increased pricing built into the documentation in the event of such a draw can cause the school district to refinance the obligation.

Risk Mitigation for COPs

The identified risks for COPs will vary based on the structure of the transaction. Staff is in the process of developing repayment sources and risk mitigation factors for different risk scenarios and will bring them back to the Committee for review and approval as a part of the final program proposal. These risk mitigation factors will likely include requirements for debt service reserves, reserves for economic uncertainties, business interruption insurance, property collateralization, and use of the intercept mechanism. The use of specific factors or combinations thereof will likely vary with the risk parameters of the issuance.

Attachment 3

PROPOSED
RESOLUTION OF THE
CALIFORNIA STATE TEACHERS' RETIREMENT BOARD
INVESTMENT COMMITTEE

SUBJECT: School Bond Credit Enhancement

Resolution No. ________

WHEREAS, the Investment Committee of the California State Teachers' Retirement Board is responsible for recommending to the Board, investment policy and overall investment strategy; and

WHEREAS, the Investment Committee has previously amended the Credit Enhancement Policies to include school districts and other employing agencies in the existing program subject to the 25% Internal Revenue Code Safe Harbor provisions; and

WHEREAS, the Investment Committee has received and reviewed the proposed school bond credit enhancement structure being considered by the California School Financing Authority, and has heard oral presentations from Staff; and

WHEREAS, the Staff has recommended that CalSTRS continue to work with the California School Financing Authority to further clarify the role of CalSTRS in such a program; and

WHEREAS, upon the final approval of a program design by the California School Financing Authority, staff will come back to the Teachers' Retirement Board with a final recommendation regarding the role of CalSTRS in the final program design; Therefore be it

RESOLVED, that the Investment Committee of the California State Teachers' Retirement Board authorizes the participation of school districts and other employing agencies in the existing credit enhancement program subject to the 25% Internal Revenue Code Safe Harbor provisions and directs Staff to work with the California School Financing Authority and development final recommendations regarding the role of CalSTRS in the School Bond Credit Enhancement Program offered by the California School Financing Authority.

Adopted by:
Investment Committee
On ______________________

____
James D. Mosman
Chief Executive Officer